



June 2009

## Complying with ERISA's Fidelity Bonding Requirements

The Employee Retirement Income Security Act of 1974 (ERISA) requires that every person who handles ERISA plan assets be covered by a fidelity bond.<sup>1</sup> This *Fidelity Bond Update*<sup>2</sup> answers common questions about ERISA's fidelity bonding requirements that The Segal Company frequently receives from our clients. In light of relatively recent guidance from the Department of Labor (DOL) in its Field Assistance Bulletin (FAB) No. 2008-04,<sup>3</sup> The Segal Company is now able to give more specific answers than in previous issues of *Fidelity Bond Update*.

### ANSWERS TO COMMON QUESTIONS ABOUT ERISA'S FIDELITY BONDING REQUIREMENTS

#### What must be done to comply with ERISA's bonding requirement?

To comply with ERISA's bonding requirement, the key questions to answer are:

- > Who must be bonded?
- > How should a bond be structured?
- > What limit of liability is required?
- > What scope of coverage is required?

This *Fidelity Bond Update* answers these and other questions.

*Bonds marketed as being "ERISA-compliant" may not fulfill all of the ERISA bonding requirements.*<sup>4</sup> Consequently, plan fiduciaries, whom the DOL will hold responsible for compliance with ERISA's fidelity bonding requirements, need to consider their alternatives carefully before making a decision.

#### Who must be bonded?

The ERISA standard is that each person who handles plan assets must be bonded. This may include the plan's fiduciaries, its employees and plan vendors. For a plan vendor, the DOL's focus is on the vendor's "natural person" employees. The "ideal" bond, therefore, not only names the plan as the insured and covers the plan's fiduciaries and employees, it also covers any natural persons employed by a vendor who would be required to be bonded.

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<sup>1</sup> See Section 412 of ERISA (Section 1112 of Title 29 of the United States Code (29 USC 1112)). Related Department of Labor regulations are found at 29 C.F.R. 2550.412-1 and 2580.

<sup>2</sup> *Fidelity Bond Update* is a periodic publication of The Segal Company's National Fiduciary Liability Insurance Practice (NFLIP).

<sup>3</sup> The FAB, which was issued on November 25, 2008, can be found at <http://www.dol.gov/ebsa/pdf/fab2008-4.pdf> For information about it, see Sibson Consulting's January 2009 *Bulletin*, "DOL Issues Welcome Guidance on ERISA Fidelity Bonding Requirements": <http://www.sibson.com/publications/bulletins/jan09FAB2008-4.pdf>

<sup>4</sup> For an example of a bond with an "ERISA compliance endorsement" that did not provide full coverage, see the decision of the Ninth Circuit Court of Appeals in *Rosenbaum v. Hartford*, 104 F3rd. 258 (9<sup>th</sup> Cir. 1995): <http://caselaw.lp.findlaw.com/cgi-bin/getcase.pl?court=9th&navby=case&no=9455579>

One carrier is going a step further. Through a new endorsement introduced by this insurer, coverage has been expanded to "...any other natural person who handles Employee Benefit Plan assets, *whether or not required to be bonded...*" [italics added for emphasis]. For this insurer, coverage is now automatic not only for the employees of a plan vendor, but also for the employees of entities typically exempt for ERISA's bonding requirements, such as banks and insurance companies. It also means that, with this particular coverage, an employee of a non-fiduciary service provider would also be covered if he or she embezzles plan assets. For clients that use Segal's NFLIP as their fidelity bond broker, NFLIP will seek to have this endorsement added to all new and renewing ERISA fidelity bonds for this insurer.

### How should a bond be structured?

There are three approaches to structuring fidelity bonds, categorized by Segal's NFLIP as narrow, moderate and broad. The three approaches are described below:

- **Narrow** These limited fidelity bonds only cover a plan's fiduciaries and its employees for fraud or dishonesty. Vendor employees are not covered. Specific third-party perils coverage is not provided. The advantage of this type of bond is that it has a low premium. In 2008, NFLIP's database showed the average cost for a \$500,000 bond of this type to be approximately \$250 per year. The disadvantage is that it creates a significant administrative and fiduciary burden because the plan sponsor has to maintain a current list of plan vendors that handle plan assets and assure that each of these vendors purchases fidelity bonds that are ERISA compliant.

The DOL's FAB clarifies that a plan vendor's bond must:

- Name the plan as an insured,<sup>5</sup>
- Have a limit of liability equal to the amount required by ERISA for an individual plan regardless of how many insureds are scheduled (*i.e.*, listed) in the bond, and
- Otherwise, be compliant with ERISA.<sup>6</sup>

Fiduciaries and plan administrators will have to pay closer attention to plan vendor bonds and may not be able to rely on a plan vendor contractual warranty or representation or representation. Likewise, a certificate of insurance in lieu of review of the actual bond may no longer be sufficient.

- **Moderate** This bond format includes the same coverage as the "narrow" bond, but, by endorsement, can add coverage for plan vendors or specific third-party perils. Plan vendors must be scheduled and updated to reflect changes. This approach still requires the plan administrator to track plan vendors because the bond's schedule must be kept current. Many plans select this approach to purchase only the specific third-party peril coverage. The degree to which its premium cost is increased depends on whether one or both coverage enhancements are purchased and how many plan vendors are scheduled.
- **Broad** This bond goes the furthest to cover all who must be bonded. It covers not only the plan's fiduciaries and employees, but, as mentioned earlier, any other natural person who handles employee benefit plan assets, *whether or not required to be bonded*. No scheduling or interim updates are required. The third-party peril coverages are also available. The clear advantage of this type of bond is its broad definition of whom is an insured and the lack of any interim reporting requirements. The disadvantage is that the premium is substantially more expensive.

Because DOL guidance is clear that all of these approaches are acceptable,<sup>7</sup> fiduciaries must decide which structure to use.

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<sup>5</sup> FAB Q&A 31

<sup>6</sup> For example, see FAB Q&A 10 and 22-24.

<sup>7</sup> See FAB Q&A 10 and 22.

### **What limit of liability is required?**

The required limit of liability is formulaic. The bond limit is for each person<sup>8</sup> required to be bonded and must equal 10 percent of the plan assets “handled,”<sup>9</sup> subject to a minimum bond of \$1,000 and a maximum bond of \$500,000. This maximum limit of liability increases to \$1,000,000 if a plan’s assets are invested in securities of any sponsor or contributing employer, unless these investments are via a “pool” such as a mutual or index fund.<sup>10</sup> If more than one plan or insured exists within a bond, the ERISA plan has first recovery rights. The limit of liability must be sufficient for the ERISA plan to be protected as if it were the only insured. Depending upon how many plans are listed as insureds, this may mean that a bond offering \$500,000 or \$1,000,000 for a specific plan will require an overall limit in the tens of millions of dollars.<sup>11</sup>

### **What scope of coverage is required?**

As defined by ERISA, “fraud or dishonesty” is the scope-of-coverage requirement.<sup>12</sup> The bond is intended to protect the plan from loss by reason of fraudulent acts or dishonesty on the part of persons required to be bonded. Many bonds sold by insurance companies use a different standard of coverage and this standard of coverage may not be ERISA compliant. Therefore, every bond presented for ERISA compliance must be reviewed to make sure the coverage standard is “fraud or dishonesty.” In addition, ERISA does not allow for a deductible for the required \$500,000 or \$1,000,000 limit of liability.<sup>13</sup> A deductible may apply to amounts in excess of the required amount or to the non-mandated third-party peril coverage.

### **Is broader coverage an option?**

Yes. Broader coverage exists and having complied with ERISA’s bonding requirements, fiduciaries may want to evaluate broader coverage. The Segal Company recommends two areas for consideration:

- Specific named-peril coverage for acts committed by third parties, who are not insured under the ERISA bond and
- Higher limits of liability for plans with significant assets.

Because many financial records are maintained and transactions conducted via computers, there is a risk that third parties can hack into computer systems to steal plan assets. Many plans still issue paper checks and third-party forgery is an exposure. The Segal Company recommends that fiduciaries consider purchasing endorsements to the ERISA bond to include third-party computer fraud, wire transfer fraud and forgery to provide protection for these types of losses.

For plans with assets in the tens or hundreds of millions, or even billions, The Segal Company recommends that fiduciaries consider whether \$500,000 or \$1,000,000 limit of liability is sufficient.

### **Is a fidelity bond always required for sponsors of qualified plans?**

ERISA’s fidelity bond requirements will apply to most ERISA plans and vendors. There is, however, a narrow exception: no fidelity bond is required for plans that are “completely unfunded.”<sup>14</sup> For this purpose, a plan is “completely unfunded” if its benefits are paid only from the general assets of a union or employer, and the

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<sup>8</sup> While ERISA’s requirement is an “each person” limit of liability, the fidelity bond works on a “per loss” basis. Subject to specific caveats, “per loss” means the limit of liability applies to each loss. Two examples will help clarify: If plan employees A and B collude to embezzle \$1,000,000 and the plan has a \$500,000 fidelity bond, the maximum recovery will be \$500,000 because the collusion creates a single “loss.” However, if plan employees A and B, acting completely independently of each other, each embezzle \$500,000, then the maximum recovery will be \$1,000,000 because each will be considered a separate “loss.” See Q&A 40 for additional information.

<sup>9</sup> “Handled” is a defined term within the DOL ERISA regulations. See 29 CFR 2580.412-6.

<sup>10</sup> See Q&A 35-40.

<sup>11</sup> For example, see FAB Q&A 22-24.

<sup>12</sup> See FAB Q&A 1.

<sup>13</sup> See FAB Q&A 30.

<sup>14</sup> See FAB Q&A 12.

assets are not segregated in any way. A plan is not considered to be “unfunded” if, for example, benefits are paid by insurance or if contributions are held in and paid out of a trust.<sup>15</sup>

Certain plan vendors such as banks, insurance companies and security brokerage firms may be exempt from ERISA’s fidelity bond requirements provided they comply with their own regulatory bonding requirements.<sup>16</sup>

## CONCLUSION

ERISA’s fidelity bond requirements are broad and complex. The Segal Company recommends that fiduciaries revisit their plan fidelity bonds and bond procedures in light of the DOL guidance to make sure they are compliant. Compliance can be achieved through one bond or, alternatively, through several bonds. The former is substantially more expensive; the latter involves more administrative process, oversight, and coverage compliance. In every instance, each bond must be carefully reviewed to make sure it is ERISA compliant. Finally, fiduciaries need to consider whether broader coverage, even if not mandated, should be purchased.



*The Segal Company does not provide legal advice and nothing in this Fidelity Bond Update should be considered to be either legal advice or a binding interpretation of coverage. Legal counsel should be consulted on all legal documents and ERISA compliance issues.*

*If you have questions about FAB 2008-04 or fidelity bonds, contact one of the following experts or any other member of Segal’s National Fiduciary Liability Practice (NFLIP):*

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**Members of NFLIP will discuss fidelity bonds in a complimentary webinar scheduled for Thursday, September 17, 2009 at 1:00 p.m. Eastern Daylight Time. To participate in that webinar, Fidelity 101, and other NFLIP webinars, [register here](#).**

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<sup>15</sup> See FAB Q&A 13.

<sup>16</sup> See FAB Q&A 15. Note, however, that while certain entities are exempt from ERISA, the coverage under their regulatory bond may not be as broad as the coverage under a plan’s ERISA bond.